Eagle Strategies LLC

The Eagle Edge

Quarterly

MARKET & ECONOMIC OUTLOOK

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On the Radar Screen

1. **Labor markets are perhaps the best concurrent indicator of economic health.** Our expectation is that new unemployment claims will rise steadily here, and we will be monitoring this weekly data series carefully for confirmation that we are entering recession.
2. **With the US economy driven primarily by household spending,** subdued consumer confidence may be another indicator. The trajectory matters.
3. **A recent uptrend in credit card delinquencies** suggests that some households may already be in over their heads.
4. **More so than anything else, stock market gains have been driven by an interest in generative AI.** Google search terms indicate that interest may have peaked. To be determined whether that has any implications for stock prices.

Insights from Multi-Asset Solutions' Portfolio Managers

"When the broader market takes its cues from narrative rather than data, an idiosyncratic event that changes that narrative can have profound consequences."

– Cameron Crise

If it is always darkest before the dawn, is it also brightest before dusk? The public release of ChatGPT in late 2022 has propelled public interest in generative artificial intelligence, its potential applications, and the stock of mega-cap tech companies presumed most likely to benefit therefrom. The Magnificent 7, as they have come to be known—Alphabet (Google), Amazon, Apple, Meta Platforms (Facebook), Microsoft, NVIDIA, and Tesla—have enjoyed tremendous year to date price appreciation, lifting broad market indices to some heady gains even as all other stocks, on average, have gone nowhere. What might be the implications?

While some stock indices, particularly the NASDAQ, paint a rosy picture of the future, numerous conventional metrics point toward mounting economic stress and the potential onset of recession. A short, far-from-exhaustive list includes:

1) Index of Leading Economic Indicators: A composite of several market variables produced by the Conference Board, the LEI suggests we may already be in recession;

2) Purchasing Managers' Indices: Likewise, a survey of companies in the manufacturing space is already in contraction territory. While responses amongst service sector companies are more positive and still point to modest expansion, here too the index has deteriorated significantly in recent months;

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3) Bank lending standards: Senior loan officers indicate they have become considerably more restrictive in their willingness to extend new loans to both businesses and households. These tighter lending standards, coupled with higher rates, are likely to impede business expansion, constrain consumer spending, and exacerbate the economic challenges already in evidence.

The labor market is arguably the most important barometer of economic health. A very low headline unemployment rate, large number of open positions, and consistently solid monthly payroll additions all suggest that conditions are just fine on this front. Yet even here, some stress fractures are appearing. Weekly new unemployment claims are in an uptrend, layoff announcements have climbed, and household perceptions of job availability have deteriorated.

Big tech has captured the imagination (and dare we say exuberance?) of the investing public, but economic indicators and analyst earnings forecasts suggest the typical company outside of this exclusive set is having a far more difficult go of it.

"A wise man changes his mind, a fool never." – Proverb. Traditional tools of financial analysis suggest the economy and markets may be on an unsound foundation, and yet GDP readings remain in positive territory and large cap stock prices are holding their ground. Perhaps there are extenuating circumstances that need to be taken into consideration? In 2022, economic resilience was commonly attributed to excess savings accumulated during the pandemic. More recently, credit has instead been assigned to the productive capacity of artificial intelligence. Phrases such as "exponential improvement," "permanent cost reduction," "bionic knowledge workers," and "intelligence as a service" are being bandied about. We are by no means oblivious to the enormous potential of AI, robotics, and other technologies to enhance productivity, expand output, remedy worker/skills shortages, and relieve inflationary pressures. But it takes time for business to embrace, implement, and reap the benefits of these emergent technologies. It's possible that capital markets have gotten ahead of the real world implications of AI. We've seen similar phenomena in the past, most notably in the dotcom era when the widespread adoption of the internet promised to change the world (which it has, just not in a way or speed that justified the price action of the late 90s). More recently, we've seen mini bubbles in digital assets (NFTs, cryptocurrencies) and "innovative/disruptive" technology inflate and then deflate. We suspect that shades of the same can be seen in the mania surrounding the Magnificent 7 and the general aura of generative AI today.

"One of the biggest mistakes you can make is to think that overpriced and going down tomorrow are synonymous. Markets that are overpriced often keep going." – Howard Marks. The market rally that began last October has come even as consensus earnings expectations have fallen, which is to say that it has been entirely a function of valuation—and then some! We find such enthusiasm surprising given the broader trends in business activity. Believing exuberance to be the apex predator of investors in a frothy market, we certainly don't wish to get caught up in the excitement ourselves. But we also understand that

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mispricings can persist, and even worsen, for long periods of time. Accordingly, we hew fairly closely to our benchmarks. By our lights, equities represent a poor value proposition, and so our portfolios are underweight equity—but only slightly, since we know this posture could work against us for some time yet. Likewise, we favor value over growth. It's been a pain trade here in 2023, but we are resolute in our conviction that it will pay off eventually. "If you participate in the enthusiasm then you'll also participate in the correction" (Howard Marks again). We'd prefer to skip both the outsize runup and the painful ride back down.

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